Remarks of
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Federal Energy Regulatory Commission

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It is certainly a pleasure being with you this afternoon. I appreciate the invitation from UBS Warburg to present some thoughts on today's dynamic energy industry. Such an impressive gathering of some of the world's leading utility companies, analysts and investors illustrates the growing importance of the global energy sector and the need to understand the opportunities and risks that are faced by today's energy companies. I hope that my insights as a federal energy regulator will add, in a meaningful way, to the mosaic of information that you will be discussing over the course of these two days.

As close observers of trends in the energy sector, you are probably interested in the activities of my agency — the Federal Energy Regulatory Commission. I know that the regulatory "climate" is an important factor in the financial analysis of the energy industry and individual companies. Therefore, I thought a brief highlight of some current regulatory issues might be of interest to you.

Over the past 10 to 15 years, FERC has maintained a consistent vision and regulatory outlook. We have committed to restructure these industries, which are so vital to our Nation's economy, from a regime of "command and control" regulation to one in which competition and market forces are playing much larger roles. For example, we have gone from a traditional, cost-based approach for pricing wholesale electricity to a market-based approach. Put simply, we are now in the business of promoting competition in the industries we regulate. In so doing, our goal is to help transform natural monopoly industries into robust and efficient competitive markets that result in more and better choices for consumers.

In restructuring the electric industry, FERC has used an approach similar to that used in our restructuring of the natural gas industry. That is, requiring open-access of the electric transmission system and ordering the functional unbundling of vertically-integrated utilities. However, the pace of restructuring in the electric industry is occurring much faster than it did in the gas industry. We have come a tremendous distance in the electric industry in the past four years and the pace of change is brisk. By contrast, restructuring in the gas industry has taken almost 15 years and work is still ongoing. The electric industry is making huge strides to address the economic and engineering inefficiencies that currently exist in the operation and expansion of the transmission system. The Commission, as well, is taking strong steps to address these inefficiencies.

In 1996, FERC required electric utilities to unbundle their generation and wholesale power merchant functions from their transmission function and to file open-access transmission tariffs. Our goal for restructuring the electric industry is to create efficient and robust competitive wholesale markets. Even though this is a difficult task, our efforts are proving to be successful. In addition, many states are unbundling energy services at the retail level and allowing consumers to choose their own electricity and natural gas suppliers.

The transformation taking place in the electric industry has been both challenging and exhilarating as we continually observe the dynamic changes that emerging competition is bringing to bear. For the most part, these changes have been positive and have advanced the Commission's goal of establishing open, non-discriminatory and competitive wholesale energy markets. However, some of these changes, especially in the electric industry, have been alarming and have shown us that the path to competition will, at times, be complicated. Obviously, regulators must keep their sights on the positive outcomes that can result from restructuring, even if they take time to develop. In this regard, restructuring of the natural gas industry can offer us some inspiration. One thing that gas unbundling has done is to create an environment where utilities are now providing new and innovative services tailored to meet the needs of unbundled

consumers. The same innovation happened in the telecom industry and I know it will happen in the electric industry as well.

It is important to keep in mind that the markets FERC regulates are not yet fully competitive, and we are in the process of redefining our regulatory approaches to meet new problems. Most of our work today relates to seeking ways to encourage and nurture competition and to allow markets to evolve as unimpeded as they can, while continuing to fulfill our consumer protection mandate. On this point, I believe it is very important that regulators be mindful of the concerns and expectations of consumers. During this transition to competitive markets, regulators must give consumers honest and realistic expectations. While competition will bring choice, innovation and efficiency to consumers, it will also likely bring fluctuating prices. Consumers have a right to know what they might expect from the changes taking place in today's electric industry. This will serve to reduce the uncertainty and confusion that can result from the imperfections of a young market.

Regulators today are called upon to achieve a delicate balance in the emerging competitive marketplace. FERC must continually gauge these fledgling markets to determine when to stand back and let market development take its course, and when it is necessary to take some action to address specific circumstances. Achieving that balance is the common thread that runs through most of FERC's deliberations these days.

The price spikes and volatile bulk power markets confronted by California consumers this past summer illustrate the kind of regulatory dilemma FERC faces with respect to markets that are not yet mature. FERC is charged with knowing when it is necessary to take immediate action that often leads only to short-term solutions, such as the imposition of price caps, and when to forge ahead with our long range regulatory goals that will lead to economically sound and lasting solutions. This kind of decision can only be made on a case-by-case basis.

As far as price caps are concerned, I believe that FERC must be very careful in their use. Price intervention by FERC can easily send the wrong signal to the market. Price caps could also exacerbate a troubling situation that currently exists in the market—a shortage of energy supply—by discouraging generators from serving the markets. I believe we must find ways to encourage supply into the market and to ensure a sufficient generation and transmission infrastructure, so that the market is healthy in the long run. Having said that though, I also believe that the limited use of price caps can be appropriate in the imperfect markets we are seeing today if they are carefully structured and temporary. I view such price caps as a bridge to competition. If price caps help get us where we want to be—in well functioning competitive markets absent of heavy-handed regulation—then they serve as a useful transition tool.

The circumstances in California this past summer have been disturbing, to say the least. We have witnessed, for the first time, retail customers experiencing the volatility and uncertainty of wholesale electric prices. This has sent shock waves through the electric industry that threatens to impede the continued progress that has been made in restructuring the industry. Regulators must ensure that California is not the catalyst for a retreat away from our goal of transforming the industry into a competitive and open market. I continue to believe that robust competitive wholesale bulk power markets are attainable—by moving forward, not retreating—and by taking firm steps to address the market imperfections. I am confident that we can arrive at appropriate short-term and long-term solutions to these problems so that we can stay the course toward competitive markets.

In order to do so, however, I believe that FERC must concentrate its efforts primarily in two areas. First, we must expand and enhance the Nation's transmission system and ensure that it is efficient and that access to it is open and non-discriminatory. Second, we must concentrate on increasing the supply of electric energy in the markets.

First, with regard to transmission expansion, the electric delivery system that exists in the U. S. today was never intended to carry the volumes of electricity that is

currently being traded. This system was originally constructed by vertically-integrated utilities to move power from their generating plants to their customers. It was never envisioned to carry the amount of interstate transactions occurring today. According to a report put out by EEI, the number of electricity transactions between regions increased from 25,000 in 1995 to 2 million in 1999. This increased trading volume is leading to congestion and could start threatening reliability.

Obviously something needs to be done to enlarge and upgrade the Nation's electric transmission system. Unfortunately, FERC currently lacks specific authority under the Federal Power Act to site new transmission facilities. This is the area in which we must rely on our colleagues at state commissions who possess siting authority. In the past, I have been comfortable with that restriction on FERC's siting authority, preferring to maintain the existing role of State authorities in the siting of these facilities. However, my thinking on this issue is changing. There could likely come a point when the shortage of available transmission capacity becomes, not just a State issue, but a national and interstate commerce issue. If that happens, I believe that FERC must have a role, even if it's a limited role, in the siting of new transmission infrastructure. The continuing good health of our Nation's economy depends on a free-flowing supply of electricity. That won't happen unless there is an adequate amount of available transmission capacity.

But FERC is taking decisive steps to address this issue by encouraging the formation of Regional Transmission Organizations (RTOs). The Commission's Order No. 2000, issued at the end of last year, dealt exclusively with the need for RTOs and the benefits that they will bring to competitive wholesale markets. In our Order, we stressed our belief that RTOs can successfully address many of the remaining barriers and impediments to a full wholesale competitive electricity market. We found that RTOs may eliminate undue discrimination in transmission services that can occur when the operation of the transmission system remains in the control of vertically integrated utilities. We also found that RTOs can improve grid reliability, improve market performance, and facilitate lighter handed regulation.

Important among those benefits is that RTOs will improve grid efficiencies and reliability. One way that RTOs will help in that regard is by allowing for more efficient regional planning for transmission and generation investments. In Order 2000, we said that RTOs must have the ultimate responsibility for both transmission planning and expansion within their regions.

In order to encourage the formation of RTOs, FERC stated its willingness to consider innovative pricing proposals for transmission owners who join RTOs. Order 2000 discussed several possible rate treatments that could help spur RTO formation. These include: (1) the use of performance-based rate regulation, such as price incentives and performance standards; (2) allowing a higher return on equity on transmission plant; (3) allowing the transmission owner to retain the benefits of cost savings attributable to RTO formation; (4) acceleration of transmission cost recovery in rates; (5) liberalized allowance of levelized or non-levelized rate methods; and (6) incremental pricing for new transmission investments.

While I will be open to new ideas on these and other innovative rate treatments, I find particularly compelling the Commission's use of return on equity (ROE) policy as an incentive to form RTOs. In order to be most effective, the Commission's return policy must accomplish three things: (1) we must allow a return on equity sufficient for a utility to attract investment capital; (2) utilities must be able to realize a return on equity commensurate with returns earned by businesses with comparable risks; and (3) our risk analysis must factor in both business and financial risks. I believe the use of ROE in this regard will be a simple, transparent, and effective way of encouraging the formation of RTOs. Granting reasonable ROEs to transmission owners will provide the incentives to make the necessary improvements to the transmission grid and to develop a sufficient transmission infrastructure.

Expansion of generation capacity is the second major area where FERC must concentrate its efforts. In a recent industry assessment, the North American Electric Reliability Council estimated that more than 10,000 megawatts of capacity nationally will

have to added each year between now and 2008 to keep up with the growth in demand. However, the Electric Power Supply Association stated in an August 2000 report that actual capacity additions since 1990 have been averaging only about 7,000 megawatts per year. This growing supply deficit will likely become a serious problem in the near future. For this reason, FERC and state commissions must focus on facilitating the addition of new capacity, as well as to increase the availability of demand response programs and services. We must strive to narrow the gap between the supply of electricity and the ever-increasing demand for electricity. Narrowing the gap between supply and demand can be accomplished by either increasing supply or decreasing peak demand, or a combination of the two. I believe we must approach the problem from both sides.

In order to increase the supply of generating capacity, I believe that state siting authorities must be diligent and timely in their review of certificate applications in order to facilitate the construction of necessary new capacity. As I've mentioned, there is a potential deficit in the amount of new generation capacity being brought online. Such a lack of supply is one of the primary factors cited by our staff and others as a major cause of the extreme price volatility in California this summer. However, just as with transmission siting, FERC has no role in the siting of generation facilities. Therefore, our state colleagues will be integral to this process.

Whereas most of the new supply will be large-scale generating units, I believe there are real growth opportunities over the next decade for small-scale natural gas fueled projects such as distributed generation and fuel cells. These technologies offer small consumers on-site generating options at their places of business or residence. While distributed generation and fuel cells are still in early stages of development, I believe these technologies hold much promise in the future.

On the issue of increasing demand-response programs, allowing consumers to react to price signals by modifying their usage of electricity away from high-priced peak periods will be an important component of fixing the supply problem. But in order for consumers to have the ability to shift their usage to lower-priced periods, they must have

accurate and timely price information. FERC and State Commissions must determine how best to increase the demand-responsiveness of consumers through specific programs, services and technology. I believe that in a competitive environment, there will be incentives to develop innovative demand-side services and that utilities will see benefits to offering these services to their customers.

One final note on the need for an adequate supply of electricity: In order to have fair and open competition, companies wishing to sell power must be able to get that power to the market. The role that the Nation's competitive power suppliers will play in this process is vital. Therefore, FERC must be mindful of the needs and concerns of these independent suppliers. What they seem to need most are efficient and workable regional power markets, reasonable and fair interconnection procedures and policies, sound market monitoring and intervention practices, and seamless interregional trading. Fortunately, I believe FERC's ongoing RTO process will, in large part, address these concerns.

In closing, let me reiterate that FERC is committed to staying the course toward competitive bulk power markets. The rewards of achieving competitive markets are too important for us to start slipping backwards now. Obviously, correcting the imperfections that exist in today's markets will not be easy, but it is a job that we must accomplish in as expeditious a manner as possible. I recognize there is some uncertainty in the industry about the effect that a possible change in the composition and leadership at the Commission could have on our resolve and commitment to move forward with the long-standing goal of developing competitive markets. In my opinion, regardless of what happens at the Commission as a result of the presidential election, we are on a steady course and hopefully our direction will not change.